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Supreme Court, U. S.
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CLERK

No. 364

In the Supreme Court of the United States

OCTOBER TERM, 1940

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAN ANTONIO LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. ———

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PAN-AMERICAN LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Fifth Circuit entered in the above case on April 20, 1940, affirming a decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 34–55) is reported at 38 B. T. A. 1430. The opinion of the Circuit Court of Appeals (R. 84–89) is reported in 111 F. (2d) 366.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 20, 1940 (R. 89). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether reserves required by state laws to be maintained by a life insurance company for the payment of incurred disability benefits under policies of combined life, health, and accident insurance constitute "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 10–16.

STATEMENT

From the findings of fact of the Board of Tax Appeals the following material facts appear:

The taxpayer is a life insurance company incorporated under the laws of the State of Louisiana, and during the tax year 1933 transacted business in the States of Louisiana, Oklahoma, Indiana, and Illinois (R. 36).

More than fifty percent of the taxpayer's total reserve funds held during the tax year 1933 were held for the fulfillment of its life insurance and annuity contracts (R. 36).

Among the life insurance policies issued by the taxpayer during the year 1933 were certain policies which carried additional provisions relating to certain noncancelable benefits in case the insured became totally and permanently disabled by accident or disease. These noncancelable benefits, for which in each case the insured obligated himself to pay an additional premium, were of two kinds (R. 36):

(1) Waiver of premiums by the taxpayer in case of the insured's total and permanent disability; and

(2) Both waiver of premiums and payment by the taxpayer to the insured of a monthly income in case of his total and permanent disability.

Policies of the first type, which carried waiver of premiums only in case of total and permanent disability, provided in part as follows (R. 37):

> PAN-AMERICAN LIFE INSURANCE COMPANY * * * Hereby Agrees, that upon receipt by the Company * * * of due proof * * * that the Insured has, while said policy * * * are [sic] in full force and prior to the anniversary date of said policy nearest to the sixtieth birthday of the Insured, become totally disabled, as the result of bodily injury or disease occurring after the issuance of said policy, so as to be wholly and continuously prevented thereby from engaging in his own or any other business or occupation and from performing any work for compensation

> or profit * * * and that such disability has already continued uninterruptedly for a period of at least six months (such disability of such duration being deemed to be permanent only for the purpose of determining the commencement of liability hereunder), the Company during the continuance of such disability will waive the payment of each premium under said policy * * * beginning with the premium, the due date of which next succeeds the date of commencement of such disability, provided that no premium shall be waived the due date of which is more than one year prior to the date of receipt at the Home Office of the Company of written notice of claim hereunder. * * *

Policies of the second type, which carried provisions relating to both waiver of premiums and payment of monthly income benefits in case the insured became totally and permanently disabled, contained substantially the above provision, and in addition another provision reading as follows (R. 37–38):

> 2. Pay to the insured * * * a monthly income of $10 for each $1,000 of face amount of said policy * * * such monthly income to be paid for each completed month of such continuous disability beginning with the fourth such month, provided, however, that in no case shall any monthly income be paid for the first three months of disability nor for any fractional part of a month of disability, nor for any period of disability

more than one year prior to the date of receipt at the Home Office of the Company of written notice of claim hereunder. * * *

The taxpayer at the beginning and end of the tax year 1933 maintained a "reserve for incurred disability benefits," representing unpaid and unresisted claims incurred under the above disability provisions of the respective policies as follows (R. 38):

	Beginning of year	End of year
Reserve for premium waiver benefits	$93,375.27	$113,674.60
Reserve for monthly income benefits	217,875.64	265,240.76
Total	311,250.91	378,915.36

The mean of the above reserve amounts to $345,083.13, and 3¾ per centum thereof equals $12,940.62.

The purpose of the reserve for incurred disability benefits is to enable taxpayer to pay the benefits which have occurred, but which have not yet become due. It is based upon a table which shows the rates of death and recovery from disability. The name of this table is "Hunter's Rate of Termination of Disability on Disabled Lives." The manner of setting up the reserve is to set up the present value of the probable future benefits. This is done by discounting the probable future benefits (either the waiver of premiums or both the waiver of premiums and the payment of a monthly income) at 3½ per centum compound interest, and reducing that amount with the aid of Hunter's table by the probability of the insured living and

still being totally and permanently disabled on the premium due date. This manner of setting up the reserve for incurred disability benefits does not differ from the manner in which reserves are set up on noncancelable health and accident insurance policies. The provisions in the policies which carried the noncancelable disability benefits involve life contingencies and differ from provisions of supplemental contracts which involve no life contingency. The reserve for incurred disability benefits is set up only in those policies where the insured has sustained total and permanent disability, and the waiver of premiums, or both the waiver of premiums and the payment of a monthly income, depending upon the type of policy, is subject in all cases to the continuance of such disability. The amount in the reserve at the beginning and end of the taxable year is reconciled as follows: To the reserve at the beginning of the year, add the present value of probable future benefits on claims incurred during the year, less reserves released on recoveries during the year, plus compound interest at 3½ per centum per annum. The recoveries occur either by the death of the person who is disabled, or by his actually recovering from his disability (R. 38–39).

The "reserve for incurred disability benefits" held by the taxpayer at the beginning and end of the tax year 1933 was required by the laws of the States of Oklahoma and Illinois, two of the states in which the taxpayer did business (R. 39–40), and

the source of the reserve was premium payments and income from investments thereof (R. 40).

The Board held that the taxpayer's so-called reserves for incurred disability benefits constituted "reserve funds required by law" within the meaning of the federal statute, and the Circuit Court of Appeals affirmed the Board's decision.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding and deciding that the reserves held by the taxpayer at the beginning and end of the calendar year 1933 for "incurred disability benefits" constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

2. In holding and deciding that the reserves maintained by the taxpayer at the beginning and end of the calendar year 1933 for "premium waiver benefits" constituted "reserve funds required by law," within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

3. In holding and deciding that the reserves maintained by the taxpayer at the beginning and end of the calendar year 1933 for "monthly income benefits" constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

4. In affirming the decision of the Board of Tax Appeals.

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REASONS FOR GRANTING THE WRIT

1. The decision below is in direct conflict with *New World Life Ins. Co.* v. *United States,* 26 F. Supp. 444, 460, wherein the Court of Claims of the United States held that a life insurance company writing policies of combined life, health, and accident insurance was not, under the provisions of Section 203 (a) (2) of the Revenue Acts of 1928 and 1932, entitled to include in its life insurance "reserve funds required by law" the reserves set up out of additional premiums paid for health and accident insurance covering total and permanent disability benefits. After the conflict between that case and the decision below had been called to its attention, this Court, on May 20, 1940, granted the taxpayer's petition for a writ of certiorari in the *New World Life Insurance Co.* case, No. 2, October Term, 1940.

2. The decision below conflicts in principle with decisions of this Court. It has been firmly established that the term "reserve funds required by law" as used in the revenue acts has a technical meaning and that not all reserves required to be maintained under applicable local law are "reserve funds required by law." Only reserves directly involving life insurance are covered by the revenue acts. Thus, in *Helvering* v. *Illinois Ins. Co.,* 299 U. S. 88, this Court held that reserves established on account of a "survivorship investment" feature

of 20-payment life policies, were not within the statute, saying (p. 90):

> The phrase "required by law" includes only reserves that directly pertain to life insurance. Other reserves, even though required by state statutes regulatory of the business authorized to be carried on by life-insurance companies, are not included.

See also *Helvering* v. *Inter-Mountain Ins. Co.*, 294 U. S. 686. Cf. *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109, 119; *United States* v. *Boston Insurance Co.*, 269 U. S. 197; *McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585.

In deciding that reserves held not against life insurance but held against health and accident insurance risks constitute "reserve funds required by law," the court below departed from the principles established in the foregoing decisions of this Court.

WHEREFORE, it is respectfully submitted that this petition should be granted.

FRANCIS BIDDLE,
Solicitor General.

JULY 1940.

APPENDIX

The pertinent provisions of the Revenue Act of 1932, c. 209, 47 Stat. 169, 223–227, pertaining to the tax on life insurance companies read as follows:

SUPPLEMENT G—INSURANCE COMPANIES

SEC. 201. *Tax on life insurance companies.*—(a) *Definition.*—When used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

* * * * *

SEC. 202. *Gross income of life insurance companies.*—(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

SEC. 203. *Net income of life insurance companies.*—(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that

in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

* * * * *

Article 971 of Treasury Regulations 77, as amended by Treasury Decision 4615, XIV–2 Cum. Bull. 312, approved December 18, 1935:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent.

In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future

unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any

State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

* * * * *

Prior to amendment, Article 971 of Treasury Regulations 77 read as follows:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent. The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the state insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance. * * * Reserves maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any state in which it transacts business, but the

reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7–11 of the liability page of the annual statement for life insurance companies, and items 16–19 and 26 of the liability page of the annual statement for miscellaneous stock companies, if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered.

The pertinent provisions of the statutes of the State of Oklahoma, Oklahoma Statutes (1931), Vol. 2, c. 51, Art. 1, provide as follows:

10501. *Annual calculations of obligations of life companies.*—The insurance commissioner shall annually make calculations of all outstanding policies, additions thereto, unpaid dividends, and all other obligations of every life insurance corporation doing business in this State. All valuations made by him, or by his authority, shall be made upon the net premium basis. The legal minimum standard for valuation of contracts issued before the first day of January, nineteen hundred and ten, shall be the actuaries or combined experience table of mortality, with interest at four percent per annum, and for

valuation of contracts on or after said date, shall be the American experience table of mortality, with interest at three and one-half percent per annum. The commissioner may vary the standards of interest and mortality in the case of corporations of foreign countries as to contracts issued by such corporations in other countries than the United States, and in particular cases of invalid life and other extra hazards; and value policies in groups, use approximate averages for fractions of a year and otherwise, and accept the valuation of the department of insurance of any other state or country, if made upon a basis and according to standards not lower than herein required or authorized, in place of the valuation herein required.

10502. *Funds must equal liabilities—Violation—Penalty.*—When the actual funds of any life insurance company doing business in this State, exclusive of its capital, are not of a net cash value equal to its liabilities including the net value of its policies according to the basis and minimum standards prescribed or authorized by the laws of this State, it shall be the duty of the insurance commissioner to give notice to such company and its agents to discontinue issuing new policies within this State, until such time as its funds have become equal to its liabilities as aforesaid. * * *

The pertinent provisions of the statutes of the State of Illinois, Illinois Revised Statutes (1935), c. 73, Sec. 331, provide as follows:

SEC. 331. *Assets less than liabilities—Notice to company—Failure to make a deficit good—Penalty for issuance of policy—Annual valuation of outstanding policies, etc.—Term insurance—Reserve—*

"Premium-payment period" construed. Par. 10.

* * * * *

The Department of Trade and Commerce shall annually make valuations of all outstanding policies, additions thereto, unpaid dividends and all other obligations of every life insurance corporation doing business in this State. All valuations made by it or by its authority shall be made upon the net premium basis. The legal minimum standard for valuation of contracts issued before the first day of January, 1908, shall be the Actuaries' or Combined Experience Table of Mortality with interest at 4 per centum per annum and for valuation of contracts issued on or after said date shall be the American Experience Table of Mortality with interest at 3½ per centum per annum. The Department of Trade and Commerce may vary the standards of interest and mortality in the case of corporations from foreign countries as to contracts issued by such corporation in other countries than the United States, and in particular cases of invalid lives and other extra hazards; and value policies in groups, use approximate averages for fractions of a year and otherwise, and accept the valuation of the department of insurance of any other state or country if made upon the basis, and according to the standards not lower than herein required or authorized, in place of the valuation herein required.

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